Supreme Court of the United States

OCTOBER TERM 1944

No. 137

PRUDENCE REALIZATION CORPORATION, *Petitioner,*

vs.

JOSEPH W. FERRIS, GEORGE L. LONG and HENRY LEIFERT as Trustees under a Declaration of Trust dated as of July 1st, 1938, with respect to 307 West 36th Street (Burnside) First Mortgage Participation Certificates, CITY BANK FARMERS TRUST COMPANY and MARTIN S. LINDGROVE as Trustees under the Last Will and Testament of Herman Stutzer, deceased, on behalf of themselves and other holders of certificates in 307 West 36th Street (Burnside) First Mortgage Participation Certificates, SOLOMON ZAUDERER, MILTON KIMMELMAN, IRVING ZAUDERER and CHARLES KIMMELMAN, doing business as KIMMELMAN AND ZAUDERER, on behalf of themselves and all other holders of Prudence Bonds Corporation participating certificate issue, and HUNTER L. DELATOUR, RAYMOND REISLER and JEROME THRALLS, Trustees of Realty Associates Securities Corporation, Debtor, holders of Burnside Certificates.

ON WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF NEW YORK, COUNTY OF NEW YORK

REPLY BRIEF ON BEHALF OF PETITIONER, PRUDENCE REALIZATION CORPORATION

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ON WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF NEW YORK, COUNTY OF NEW YORK

REPLY BRIEF ON BEHALF OF PETITIONER, PRUDENCE REALIZATION CORPORATION

I

As to the brief of respondents Ferris, Long and Leifert.

1. Respondents argue that despite the reservation in the plan, unless the bankruptcy proceedings accorded peti-

tioner parity by an express provision in the plan or in an order entered in the proceeding, the rights of the parties were wholly unaffected by the bankruptcy proceedings and were determinable under state law, as though there had been no bankruptcy reorganization at all. This position is untenable because upon the utilization of the Bankruptcy Act as the medium for distribution of the insolvent's assets to its creditors the rights of such creditors as among themselves became fixed and determinable in accordance with the provisions of *that* statute rather than any state system of distribution. So much was clearly decided in *Prudence Realization Corporation* v. *Geist*, 316 U. S. 89. Petitioner submits that a bankruptcy creditor's status remains determinable under the Bankruptcy Act unless, and to the extent that, a plan of reorganization modifies his right to such determination by provisions which conform to the requirement that the plan be fair, feasible and equitable. In the present case that right was not modified but merely reserved for future determination solely to avoid delay in consummating the plan (R. 16).

Even respondents admit that the bankruptcy court could have determined the status of petitioner's claim as a matter of bankruptcy law (Respondents' Brief, pp. 5, 6). As indicated in our main brief (p. 18), the only reasonable inference to be drawn from the reservation was that the question of status should be reserved for adjudication at a later time in any court having personal jurisdiction over the parties. It is highly unrealistic to argue that such a grant of concurrent jurisdiction to such a court constitutes an agreement by the guarantor to waive its right to have its claim determined in accordance with the Bankruptcy Act.

2. These respondents claim that petitioner has failed to mention a further distinction between the reservation in the *Geist* case and the reservation in this case which they contend is basic and material. The alleged material distinction is that the reservation in the *Geist* case was merely

part of the order confirming the plan, while here it was a formal, integral part of the plan, on the basis of which certificate holders consented to the plan. But the actual facts justify no distinction in law between the two cases. In the *Geist* case the order of confirmation, containing the reservation, was agreed upon and submitted by all parties in the form signed by the Court. Its language was substantially identical with that of the reservation here. However, in this case, in lieu of inserting the reservation directly in the order of confirmation, since there were a substantial number of amendments to be made to the plan relating to other matters, such amendments were drawn up separately, included as an exhibit, and approved by the Court in its order of confirmation (R. 118). In both cases, however, the reservation language was prefaced by the phrase "Anything in the plan to the contrary notwithstanding * * *" (R. 243). In the true sense, in each case the reservation was a "stop payment" order to the trustee; a direction that no distribution on the insolvent guarantor's certificates should be made under the existing provisions of the plans until the status of the insolvent guarantor's claim had been determined.

3. There is no basis for the assertion that petitioner's position is a collateral attack upon the Burnside plan. Petitioner does not question the validity of the plan nor of the order confirming it. It merely seeks a determination of the question reserved for determination in the plan. That is not an attack on the plan but its enforcement.

II

As to the brief of respondents City Bank Farmers Trust Company and Martin S. Lindgrove as trustees.

1. Counsel for these respondents appeared in the Prudence reorganization, the Zo-Gale reorganization (involved in the *Geist* case), and the other Amalgamated certificate

reorganizations. Accordingly, although they apparently suggest the contrary (pp. 6-8 of their brief), they should know that there was no material difference between the nature of the Zo-Gale and the Burnside reorganization proceedings which would render the *Geist* decision inapplicable. The plans of reorganization for the two certificate issues were promulgated in the Amalgamated proceeding before its severance from the Prudence proceeding (R. 93, 108). Upon the severance, while the caption was altered, there was no new filing of claims, nor any other step taken which directly or indirectly affected the rights of any parties as they existed theretofore. There is no justification for the statement on page 13 of their brief that the Prudence proceeding has been terminated—it has not been terminated by final order or otherwise.

2. In their brief under Point III respondents refer to the fact that the plan provided a method of distribution, in the event subordination was ultimately decreed, of the interest on the guarantor's certificates which had been segregated from the time of the guarantor's insolvency. They argue (Respondents' Brief, pp. 20, 21) that this provision constitutes an agreement between the parties: (1) that the question of participation was no longer determinable under the Bankruptcy Act; (2) that neither the insolvency of the guarantor nor the bankruptcy reorganization of the certificate issue should any longer have any effect upon the determination of the parity question; (3) that the determination of the question should be had under state law solely on the basis of the relations existing between the guarantor and the other certificate holders as such relations had existed immediately prior to and regardless of the bankruptcy and unaffected and unaltered thereby. This claim finds no support whatsoever in the record. A contention that the reservation in the *Geist* case had a similar effect was made by the trustee of the certificate issue in the *Geist* case. Certainly, no such agreement can possibly be implied from the mere

fact that the plan provided, in the event subordination should ultimately be decreed, for the distribution of the interest on the guarantor's certificates which had been segregated from the time of the guarantor's insolvency, in a manner *inconsistent* with the method of distribution applicable in the New York courts upon subordination. The reservation was intended solely to postpone adjudication of the status of the guarantor as a bankruptcy creditor, *i.e.*, whether the parity or the subordination provisions were to be applied.

The only difference between the present plan and the *Zo-Gale* plan is that here the parties agreed that if subordination was decreed the distribution should be in a specified manner, while in the *Zo-Gale* plan the parties, in lieu of specifying the method of distribution, agreed to such subordination provisions as the Court would insert upon a determination of a subordination status. In each case the adjudication of status, and therefore whether parity or subordination provisions for distribution were to be applied, was postponed. In the *Geist* case this Court held that the proper basis for such later adjudication was the Bankruptcy Act. That is the same basis to be applied here.

The attempt to exclude the effect of the bankruptcy of the guarantor because of the provisions of the guarantor's liquidation plan is similarly ineffective. Here again the rights of creditors to share in the liquidation were established under the Bankruptcy Act. The initial cash distribution under the plan was made in accordance with the bankruptcy rule of distribution (R. 47, 59). The New Loan Value Formula, rejected in New York reorganizations (*Matter of New York Title and Mortgage Co.*, 277 N. Y. 66), was an adjustment between guaranty creditors as a single group and general creditors. That is demonstrated by the classification of claims (R. 77). Moreover, the Prudence plan and order of confirmation upon which respondents rely for their argument were included in the *Geist* record (Case on Appeal, R. 63, 95), and the decision in that case is determinative here.

3. Under Point VI respondents argue for subordination on equitable grounds. For substance the argument is based upon a conclusion that petitioner's certificates were acquired by the guarantor to reduce its guaranty obligations and must be subordinated under the rule established by this Court in the case of solvent sureties (*United States* v. *National Surety Company*, 254 U. S. 73; *Jenkins* v. *National Surety Company*, 277 U. S. 258) which were distinguished in the *Geist* case at page 96.

An examination of the *Geist* decision shows, however, that this Court held the solvent surety cases inapplicable upon an analysis of the guaranty agreement and consideration of equities resulting from the insolvency of the guarantor. This Court stated the issue clearly at pages 95, 96:

> "But the question remains whether there is any equity arising from the Prudence Company's failure to perform its guaranty which a bankruptcy court should recognize as requiring the subordination of the company's interest in the mortgage to the claims of the other mortgage creditors."

That question was answered in favor of petitioner. The contract of guaranty is the same in the two cases; the guarantor's insolvency is a conceded fact, present in each case; and there is no valid reason advanced for overruling the *Geist* decision.

Respondents, however, disregard the basis of decision in the *Geist* case, and rely on the solvent surety cases in an effort to secure subordination. In that effort they ignore the nature of the guaranty, the character of Prudence's business, the actual manner of acquisition, and the effect of Prudence's insolvency.

The overwhelming proof is that the repurchase of the certificates here did not create special equities in favor of the Burnside guaranty creditors as against the other guaranty creditors, but rather; as decided in the *Geist* case, the facts support petitioner's claim that the equities require a parity determination.

Prudence was engaged primarily in the business of making mortgage loans. As the Circuit Court of Appeals said in *In the Matter of The Prudence Company, Inc.* (C. C. A. 2d, 1935), 79 F. (2d) 77 at page 80, speaking about Prudence, "Although a corporation organized under the Banking Law as an investment company has power to guarantee the mortgages and participation certificates which it sells, the element of insurance is but incidental to its mortgage business, * * *." It used its own funds to make loans secured by mortgages on real estate. At the time of making the loan it secured a "bonus" of approximately 5% from the borrower by actually advancing 95% of the face amount of the mortgage. *In re The Prudence Company, Inc.* (C. C. A. 2d, 1938), 98 F. (2d) 559, 560. As any other mortgagee, it secured an appraisal of the property (R. 37) as well as a title policy (R. 37). Thereafter, to secure additional funds for use in making further mortgage loans for profit, it created the certificate issues like the one here involved. It split up its mortgage into many parts and sold these parts of the mortgage to investors. To facilitate the sale it guaranteed to each purchaser of a portion of the mortgage the payment of principal within 18 months after the certificate matured and interest when due. Interest was guaranteed, not at the rate of 6% provided for in the mortgage, but at the rate of 5½% (R. 94). The differential of ½% was to compensate Prudence for servicing the mortgage, acting as transfer agent for the certificates, and for its guaranty. The differential was used to maintain Prudence's office and operating personnel. Its sale of certificates permitted it to realize upon the bonus received from the mortgagor and to use that money as well as the actual cash loaned.

The only basis upon which Prudence could continue in business for profit at any time was to maintain a group of investors in the mortgages which it received on making new loans. Its practice therefore at all times was to keep its customers, or "clients" as they were called (R. 144, 157, 170). Its practice before January, 1932, as well as after,

was at any time on application, to lend to holders of the certificates up to 90% on the security of the certificates, or to repurchase them at a 10% discount (R. 144). At or near the maturity of any issue it sent salesmen out to try to sell new issues in exchange for the maturing certificates (R. 167).

On January 1, 1932 the 18 months clause was invoked to postpone the principal guaranty obligation (R. 145). An amortization payment due on the Burnside mortgage on January 1, 1932 was not paid. The result was that with respect to certificates in the amount of such amortization which matured on that date the 18 months deferment began to operate. The remaining unmatured certificates did not become due until July 1, 1932, and the guaranty of principal of such certificates did not mature until 18 months thereafter, or January 1, 1934.

In February, 1932, Reconstruction Finance Corporation approved a loan of $20,000,000 for Prudence (R. 154). The securing of the loan was consistent with Prudence's continuance in business. Its practice with respect to repurchase of its own securities continued. Efforts to secure reinvestment by the client were made as usual, and the fact that there was a reinvestment did not mean that the client had first insisted on receiving his money (R. 167). Prudence's acquisition of certificates here did not differ from its acquisition of certificates of other issues; they were acquired as part of the regular practice of the company (R. 170).

When Prudence had originally sold the mortgage for 100%, after having paid only 95%, it made a profit. When it reacquired certificates at a 10% discount it made a further profit. When it reacquired it by selling a portion of another mortgage it was again realizing a profit on the new mortgage. That was its business.

Prudence was not a surety company. As indicated, its business for profit was not based upon receiving a premium for lending its credit, its profit to be gained when its liability on its guaranty did not mature. That was the busi-

ness of National Surety Company, involved in *United States* v. *National Surety Company* and *Jenkins* v. *National Surety Company, supra.* There the first connection between the surety and the assets of the primary obligor arose upon default by the obligor. There the surety's bond was required before the contractor could secure the contract or before the bank could receive the deposits. Here Prudence made an investment by lending money. The guaranty was subsequent in time and represented its contractual obligation to the purchasers of shares in that investment that the investment would be paid. As this Court said in the *Geist* case at pages 96, 97:

> "By that contract the guarantor pledged only its personal obligation for the payment of the certificates. It gave to the certificate holders no lien upon, or other priority in its interest in the mortgage more than to its other assets."

The purchaser of the certificate received not just a surety bond from Prudence but a share in a mortgage. That was a salable asset in his hands as well as in the hands of Prudence, with or without the guaranty. If the property was worth less than the mortgage and cost of acquisition, the deficiency was chargeable against the guarantor's assets; not against any special asset, but against the general assets based upon the unsecured guaranty contract. That was true of every guaranty contract of Prudence.

When Prudence became insolvent its general assets, including the certificates owned by it in this issue, became the source of payment of all of its guaranty claims. No guaranty creditor was entitled to any preferential treatment as against any other, and no property justifiably could be taken out of the general estate to transform the Burnside certificate holder's guaranty obligation into a secured debt merely because the insolvent guarantor having once sold its original investment had repurchased a portion of it. There is no doubt that if Prudence had again resold the reacquired certificates, with or without

the guaranty, the purchasers would have been entitled to parity and the cash received would have been part of the fund presently available to pay all of the insolvent guarantor's debts.

Petitioner, representing all of the insolvent's creditors, urges that there is no equity in subordinating the remaining creditors and in giving to the Burnside certificate holders "the exclusive benefit of a security for which they have not bargained" (*Prudence Realization Corporation* v. *Geist*, 316 U. S., at p. 97).

III

As to the brief of the Securities and Exchange Commission.

1. Under Point II of the Commission's brief it urges subordination as a matter of equity and practicality under federal law. To the extent that the argument proceeds upon the conclusion that reacquisition was solely as an incident of the guaranty, the discussion of the similar conclusion of respondents City Bank Farmers Trust Company, et al., under II of this brief is applicable here.

Whatever validity the balance of the Commission's argument would have if the solvent guarantor were claiming parity status, it is inapplicable here where parity is claimed, not by the solvent guarantor, but, after its insolvency, by the guarantor's creditors holding the same guaranty claims similarly in default.

On page 20 of its brief the Commission says (1) that if the guarantor had respected its guaranty obligation it would have made pro rata payments on account of its guaranty to the extent of available funds and there would have been no question of subrogation until the guaranty had been paid in full, and (2) that unless subordination is enforced the guaranty creditors will have been prejudiced by the failure to make such pro rata payments in the

attempt of the guarantor to escape full responsibility on its obligations.

This argument presupposes that only the Burnside Issue obligation matured, and that the 18 months' clause was invoked only in this case. The contrary, of course, was true (R. 145, 219). If pro rata payment had been made it would have been made not only to Burnside certificate holders but to over $22,000,000 of guaranty creditors in 1932 and to over $32,000,000 of guaranty creditors in 1933. Such a distribution would have accomplished what petitioner urges here: pro rata distribution of assets to all guaranty creditors, rather than preferential payments to Burnside guaranty creditors at the expense of the remaining similar guaranty creditors.

As previously indicated, the argument on pages 20, 21 and 22 of the Commission's brief does not deal with the facts in this case. The right of the solvent guarantor to share on a parity is not in issue here. Petitioner is not the guarantor but the creditors of the guarantor, who were all equally hurt or benefited by the guarantor's reacquisition of these certificates. Moreover, in the present case the certificate gave to the guarantor the right to hold certificates for its own account on a parity with other certificates (R. 32, 34).

On page 23 the Commission is disturbed by the possibility that holdings by the insolvent guarantor's estate may be utilized to the detriment of certificate holders in a particular issue. This is an assertion of a non-existent limitation upon a reorganization court's power and obligation to approve only a fair, feasible and equitable plan of reorganization. Particularly does this argument seem inapplicable since, under Chapter X reorganizations, the Commission itself participates in order to guard against any such overreaching.

The conclusion on pages 23 and 24 that subordination will facilitate the guarantor's reorganization is illusory. Even if subordinated, the guarantor's holdings are entitled to classification in the certificate issue reorganizations. The

insolvent guarantor's trustees are under obligation to participate to make certain that appraisals of the underlying property are proper and that the provisions relating to their holdings are fair. The suggestion that certificate holders then will be less interested in realizing upon their claim against the guarantor's estate is not persuasive. It is to be doubted as a matter of practical experience that where an estate exists, creditors having a right to participate will neglect to file and prosecute their claim. Moreover, certainly this Court will not approve a procedure which will discourage the filing of a valid and enforceable claim, thereby preferring the remaining creditors.

As indicated, any considerations of practical administration which possibly may have had influence upon the New York courts in their reorganizations are not present here. The Commission overlooks the fact that in the state court reorganizations the guaranty creditor is a secured creditor of the guarantor. *Matter of New York Title and Mortgage Company*, 160 Misc. 67, reversed on other grounds, 277 N. Y. 66. In bankruptcy they are not secured creditors, but general creditors for the full amount guaranteed without reduction of the value of the guaranteed security. (*Ivanhoe Bldg. & Loan Assn.* v. *Orr*, 295 U. S. 243). Practical considerations present in the case of state court reorganizations under such circumstances cannot obtain under the present Bankruptcy Act.

In its final argument, dealing with claims of general creditors, the Commission urges that general creditors must be held to have loaned money subject to equities of subordination. As indicated, however, the guaranty creditors are general creditors too. They received the same contract of guaranty as was given to the Burnside guaranty creditor. The problem, therefore, remains as to the equities presently existing between such guaranty general creditors as such rights presently exist after their certificate issue reorganizations have been completed and as established by the *Geist* case, not what they would be *in futuro* if the present views of the Commission were adopted now for the first time.

It is suggested that the procedure outlined by the Commission in the case of Prudence would not have facilitated the guarantor's reorganization but by treating each issue independently would have required separate classification for each group of certificate holders, requiring separate consents, and would have rendered reorganization virtually impossible.

CONCLUSION

The judgment entered in the Supreme Court of the State of New York, County of New York, upon the decision of the New York Court of Appeals, is erroneous and should be reversed.

Respectfully submitted,

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December, 1944.